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Insurance Coverage Update

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Suits By Same Creditor on Same Debt Deemed Unrelated, But Late Notice Bars Coverage

The President of a software company who defaulted on two different loans successfully defeated his D&O insurer's arguments that coverage for the action instigated by his lender was barred by the policy's Prior or Pending Litigation Exclusion, but lost coverage due to his 16-month delay in notifying his insurer of the pending lawsuit. *Zahoruiko v. Fed. Ins. Co.,* 2017 WL 776645 (D. Conn. Feb. 28, 2017).

J. Graham Zahoruiko served as President of a software company, SpaceWeb Corporation ("SpaceWeb"), later known as Refresh Software Corporation ("Refresh") (collectively, "the Company"). Federal Insurance Company issued a D&O policy to SpaceWeb starting on October 1, 2000. That policy was cancelled on May 26, 2001, for non-payment of premium.

Later, Federal issued a new, separate D&O policy to Refresh, which was effective from December 14, 2002, to April 14, 2011. SpaceWeb, Refresh and Zahoruiko were not covered by any D&O liability policy for 19 months between May 26, 2001, and December 14, 2002.

In 1999, the Company entered a debt note in connection with a line of credit. Zahoruiko signed the note (the "1999 Note") as guarantor. On October 29, 2002, during the 19 months of no insurance, the creditor of the 1999 Note sued the Company and Zahoruiko, alleging default.

A default judgment was entered against the Company and Zahoruiko on June 16, 2003. Federal was apparently not notified of the 2002 lawsuit.

The creditor, the Company and Zahoruiko entered into a settlement agreement on July 1, 2003, without Federal's knowledge, releasing the obligations under the 1999 Note, but requiring the Company and Zahoruiko to enter a second note ("the 2003 Note"), with Zahoruiko again signing a personal guaranty.

The Company and Zahoruiko began having trouble paying the 2003 Note in May 2008, immediately before a final "balloon" payment was due. The creditor and the Company, with Zahoruiko as guarantor, executed a forbearance agreement, which delayed the balloon payment until April 30, 2012.

The creditor filed another lawsuit on July 10, 2010, against the Company and Zahoruiko for failing to meet their obligations under the 2003 Note. As the delayed due date for the balloon payment drew near, on February 3, 2012, the creditor notified Zahoruiko that it intended to seek summary judgment. Ten days later, Zahoruiko notified Federal of the 2010 lawsuit. Federal denied coverage based upon, among other things, the Prior or Pending Litigation Exclusion and late notice.

The Prior or Pending Litigation Exclusion barred coverage for losses "based upon, arising from, or in consequence of a written demand, suit, or other proceeding pending, or order, decree or

judgment entered for or against any Insured on or prior to the applicable Pending or Prior Litigation Date ... or the same or any substantially similar fact, circumstance or situation underlying or alleged therein." The policy also stated that related claims should be treated as a single claim.

Regarding Notice, the Policy stated, "Any Insured shall, as a condition precedent to exercising their rights under any Liability Coverage Section, give to [Federal] written notice as soon as practicable of any Claim."

Federal argued that the 2010 lawsuit was related to the 2002 claim, and the Prior or Pending Litigation Exclusion therefore barred coverage because the 2010 lawsuit was "based upon, arising from, or in consequence of the same or related facts, circumstances, situations, transactions or events or the same or related series of facts, circumstances, situations, transactions or events."

A U.S. District Court judge in Connecticut found that neither the Pending or Prior Litigation Exclusion nor the Related Claims language applied, reasoning that the settlement of the 2002 case, and the execution of the new note and guaranty, definitively resolved any disputes relating to the 1999 Note and extinguished any obligations under that note. Because the cases involved breaches of different notes, they cannot be said to arise from the "same or any substantially similar fact, circumstance or situation," according to the Court.

The Court found, however, that Federal properly denied coverage for the lawsuit because Zahoruiko did not provide notice of the 2010 lawsuit within a reasonable time. Under Connecticut law, in the context of notice provisions "as soon as practicable" means "as soon as can reasonably be expected under the circumstances." An insurer's duties under an insurance policy cannot be discharged due to late notice, however, unless the delay resulted in material prejudice to the insurer.

Central to the Court's analysis was the fact that Zahoruiko did not notify Federal of any claims until February 13, 2012, which was 10 days after learning that the creditor intended to move for summary judgment in the 2010 lawsuit, and a full 16 months after being served with the 2010 complaint. This was not "as soon as can reasonably be expected under the circumstances," and, indeed, Zahoruiko offered no legitimate explanation for his failure to promptly notify Federal of the 2010 lawsuit.

Zahoruiko' s failure to timely notify Federal was prejudicial for several reasons, including the fact that Zahoruiko executed a forbearance agreement in which he waived defenses to suits for non-payment of the loan, and that he incurred litigation costs defending the 2010 lawsuit. He also prevented Federal from negotiating better repayment terms or from settling the lawsuit before the defense costs were incurred. In the end, the Court granted Federal summary judgment.

Comment

Both policyholder and insurer advocates will no doubt have gripes about the Court's opinion. On the one hand, one could argue it is simplistic to conclude that the 2010 suit did not arise from the same or any substantially similar fact, circumstance or situation simply because the earlier lawsuit concerned the 1999 Note and the 2010 lawsuit concerned the 2002 Note. Part of the settlement of the first lawsuit was the conversion of the debt under the 1999 Note into the 2002 Note. It was the same debt to the same creditor.

The breadth of the Related Claims language would seem to dictate a different result. But courts analyzing relatedness often seem to drift

from the policy language in search of differences between cases.

The saving grace, as far as the insurer is concerned, was Zahoruiko's inexplicable delay in tendering the 2010 lawsuit to Federal. Likewise, policyholder advocates will criticize the Court for basing its finding of prejudice partially on the fact that Zahoruiko waived some of the defenses to suits for non-payment of the loan in the forbearance agreement, as the forbearance agreement was signed in 2008, well before the 2010 suit was brought.

In the end, this case serves two valuable lessons: (1) It can be extremely difficult to accurately predict how a court will rule on any relatedness issue, and (2) open, honest and prompt communication between policyholder and insurer regarding potential (or actual) claims is of the utmost importance.

If you have any questions about this Update, please contact the authors listed below or the Aronberg Goldgehn attorney with whom you normally consult:

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